SEPTEMBER 16, 2013

WEEKLY INVESTMENT COMMENTARY

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Expect a Gradual Fed Tapering

Stocks Rise in Advance of Fed Meeting

All eyes are on the Federal Reserve's policy meeting set for Tuesday and Wednesday of this week as investors are expecting the long-awaited announcement of a reduction (or "tapering") of the Fed's asset-purchase program. At this point, expectations appear to be that tapering will be slower and less dramatic than had been telegraphed a few months ago. That shift in expectations, along with some easing of tensions on the geopolitical front, helped stocks to a strong rally last week. For the week, the Dow Jones Industrial Average rose 3.0% to 15,376, the S&P 500 Index climbed 2.0% to 1,687 and the Nasdaq Composite advanced 1.7% to 3,722. Fixed income markets were relatively muted last week. The yield on the 10-year Treasury declined modestly, dropping from 2.94% to 2.89% (yields move inversely to prices).

Look for "Tapering Lite"

After months of waiting, investors should finally get some clarity on the issue they have been obsessing over for months: the future path of monetary policy. Our view is that given the softness in the economic data and the lack of inflationary pressures outside of oil prices, the Fed will announce only a modest reduction in the rate of their asset purchase program. Specifically, we expect the Fed will reduce the size of their monthly asset purchases from its current level of $85 billion to somewhere between $70 and $75 billion. Additionally, since this sort of reduction appears to already be priced into the markets, we think that long-term interest rates should be relatively contained over the coming months.

So why won't the Fed announce a larger reduction? First, because it doesn't have to. The Fed has a great deal of flexibility to move slowly since inflationary pressures are almost nonexistent. Last week's release of August's producer price inflation data helped confirm this benign environment. Producer prices were up only a modest 1.4% on a year-over-year basis, and without the more volatile food and energy components, prices rose only 1.1%, the lowest level since the summer of 2010.

At the same time, the economic recovery remains shaky. As we've been highlighting recently, job growth has not accelerated and wages and consumption remain soft. Moreover, the housing market has grown as a source of concern, given the tight relationship between interest rates and housing. With interest rates rising over the past few months, mortgage rates have been climbing. This situation has already had a negative impact on housing activity and has severely curtailed refinancing. The Fed will be wary about taking any action that could put the housing recovery in jeopardy and does not want to see a steep backup in yields.

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High Yield Bonds and Emerging Markets Equities Should Benefit

What, then, are the investment implications of a taper lite? We do think that near-term financial market volatility will remain relatively elevated as investors scrutinize the details of the Fed's coming announcement. In particular, there will be a great deal of focus around the question of when the Fed intends to actually increase short-term rates, which we continue to believe won't happen for some time. As we indicated earlier, however, expectations for a taper lite appear to be reflected in the markets, meaning that absent stronger economic data, interest rates are likely to remain range-bound for the coming months.

Such a backdrop does present some near-term opportunities. High yield bonds should benefit from an environment of stable rates and a slowly improving economy. Another asset class to consider would be emerging markets equities. This area of the market has been punished in recent quarters as higher interest rates and a stronger US dollar have been putting pressure on many emerging markets currencies. A more stable interest rate environment should translate into better performance for emerging markets equities, a trend that we have already started to see in recent weeks.

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